FEDERAL DEPOSIT INSURANCE CORPORATION

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MEETING OF THE ADVISORY COMMITTEE
OF STATE REGULATORS

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OPEN TO PUBLIC OBSERVATION

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WEDNESDAY,

OCTOBER 18, 2023

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The Advisory Committee convened at 1:00 p.m. EDT, Martin J. Gruenberg, Chairman, presiding.

PRESENT:

MARTIN J. GRUENBERG, Chairman
TRAVIS HILL, Vice Chairman
JONATHAN McKERNAN, Director, Federal Deposit Insurance Corporation
KEVIN ALLARD, Superintendent, Division of Financial Institutions, Ohio
CHARLES COOPER, Commissioner, Department of Banking, Texas
JAMES COOPER, President & CEO, CSBS, Washington, D.C.
MARY GALLAGHER, Commissioner of Banks, Division of Banks, Massachusetts
GREG GONZALES, Commissioner, Department of Financial Institutions, Tennessee

KEVIN HAGLER, Commissioner, Department of Banking and Finance, Georgia

MELANIE HALL, Commissioner, Division of Banking and Financial Institutions, Montana

DAWN HOLSTEIN, Commissioner, Division of Financial Institutions, West Virginia

LISA KRUSE, Commissioner, Department of Financial Institutions, North Dakota

ANTONIO SALAZAR, Commissioner of Financial Regulation, Maryland

MICK THOMPSON, Banking Commissioner, Banking Department, Oklahoma

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P-R-O-C-E-E-D-I-N-G-S

1:02 p.m.

CHAIRMAN GRUENBERG: Well, good afternoon, everybody, and I'd like to welcome you to this meeting of the FDIC's Advisory Committee on State Regulators. We really value the opportunity to interact with you and particularly today to take advantage of the opportunity to get your feedback on what you're seeing in your states and through your institutions.

I think we've been struck as it’s been indicated by the quarterly banking profiles that the banking industry in the United States generally and community banks specifically have proven to be quite resilient during, I think fair to say, very uncertain economic times. And the industry remains well capitalized. Credit quality as a general matter has remained quite good. Liquidity has stabilized after the events of earlier this year, and loan balances for the industry as a whole and community banks have

continued to grow. So that's the good news.

The other side of the story is, I think, we have a very uncertain economic environment with significant downside risk to the industry going forward. We have a high interest rate environment, which will be challenging for our institutions to manage in a variety of ways; uncertainty as to where the economy is headed; and as we're all aware, significant underlying vulnerabilities for the industry including unrealized losses on securities and loans, significant concentrations of uninsured deposits, and significant commercial real estate exposures, particularly relevant to banks under 100 billion and to our community banks, in particular.

So, while the industry remains in reasonably good shape, the uncertainty and the downside risks, I think, will probably keep us all occupied for the foreseeable future.

So, before I turn it over to Doreen

and our panel discussion to elicit your thoughts on these and other issues, maybe I'll ask our Vice Chairman Travis Hill if he would like to say a word.

VICE CHAIR HILL: Sure. I just want to say thank you to everyone for being here today. I think the FDIC's coordination with the state regulators is a critically important part of our supervision, and so look forward to the discussion today. Thanks.

CHAIRMAN GRUENBERG: Thank you. And we're also joined by our other Director Jonathan McKernan.

Thank you, Jonathan.

Doreen, it's all yours.

MS. EBERLEY: Okay. Well, since we do have several members of our Board of Directors in attendance today, I have some brief housekeeping remarks.

The Government in the Sunshine Act imposes notice and access requirements whenever

a quorum of the FDIC's Board of Directors meets to conduct or determine agency business. This meeting is not held for such purposes and does not constitute a meeting under the Act. The board members present will only engage in general or preliminary discussions that do not relate to specific proposals for action pending before the FDIC. Any specific issues for official board resolution will remain open for full consideration by the board following the conclusion of this meeting. And if you have any questions, we have some lawyers here to answer them.

Okay. And let me welcome- we have a couple of members that are participating virtually: Greg Gonzales and Dawn Holstein. Also- welcome.

And we will go ahead and jump right into it. We're going to begin our afternoon with Camille Schmidt, Chief of the Risk Insights and Analytics Section in the Division of Risk

Management Supervision; and Krishna Patel, Chief of the Economic Analysis Section in the Division of Insurance and Research. And Camille and Krishna are going to provide a brief economic overview and touch on industry risks. And during the session, we really do want to hear from you, so we're going to try to do some Q&A to get some conversation going and hear your thoughts on these risks, as well as others, and we look forward to hearing from you about what's going on in your states.

And I also want to acknowledge that Commissioner Hall, Melanie Hall, is also on the line virtually.

So, Camille and Krishna, I will kick it over to you.

MS. PATEL: Thanks, Doreen.

So, I guess if we could,-- should have a copy of your presentation in your folders. We also have it up on the screen.

So, the discussion today will be

oriented around two important issues in the banking industry, and that is funding and interest rate risk and credit risk. I'll start off the conversation with a brief economic overview and some highlights of some of these risks, and then we'll, sort of, have a question and answer session.

So, on the next slide we have a map here of economic conditions in different states. Overall, the economy this year has been relatively resilient despite recession fears, sort of, earlier this year. We expected to have a recession this year, but strength in the labor market, strength in business spending and consumer spending have held up economic activities so far.

Still the economy faces challenges, ongoing challenges, from high inflation; although inflation has come down, it's still historically high, and historically high interest rates. I think the key thing here as shown on this map is

that economic conditions vary by state. You have some states noted-- denoted here in the darker blue shading is-- it has been stronger, relatively stronger than some of the other states. Lighter blue is-- that's the weakest growth. All states grew, but some states are about near zero.

The outlook for the economy, as the Chairman mentioned, is uncertain. We've got some geopolitical risks that have moved interest rates a bit and may cause some questions about a global economic slowdown, the continued effects of higher inflation, as well as the continued effects of higher interest rates that slowed many interest rate sensitive markets such as residential real estate, commercial real estate. We'll talk a little bit more about that later. So, it's an uncertain outlook. Still the recession forecasts call for a slowdown in the economy, not quite an outright recession, although some-- the recession risks still remain

elevated.

With regard to interest rates, in the next slide, the left-hand chart shows the degree-- how sharply interest rates rose during the current cycle and how high they remain. The Federal Reserve recently slowed the pace of interest rate hikes, paused in the last meeting, but expectations are for at least one more rate hike before it holds steady and maybe potentially decline next year, although I raise a question on potential because, you know, it really all depends on the inflation picture and the labor market picture. The labor market still remains pretty strong with historically low unemployment rates. And inflation, although it has come down, there have been key components in there that remain pretty high including shelter prices, food prices. Recently energy prices have also gone up. Also, geopolitical factors may play a role in price levels overall.

And the long end, the longer-term

yields have also increased recently for a number of factors including Treasury supply, Treasury issuance, global demand for Treasuries, also kind of risk appetite among key investors. So, we've got interest rates higher all along the yield curve, but the longer rates been slower to rise compared to shorter-term rates. So, we still have that inversion that's causing potentially challenges to the banks.

And so that brings me to the next slide which shows net interest margins, which I'm sure you're all looking very closely at for the banks that you supervise. Here we have a chart that shows net interest margins over the past 15 years that provides a historic context and net interest margins for banks of different size groups.

The thing that stands out in this chart is, first of all, that net interest margins rose very sharply after declining in previous years. It rose very sharply when interest rates

started to rise and banks started to benefit from higher asset yields. But then we recently saw a turn in NIMs, so we've seen the net interest margins starting to decline, reflecting higher funding costs. Among all these banks, community banks tended to report higher net interest margins, but they also have a declining NIM as funding costs have increased.

So, in the next slide we go into a little bit more about liquidity and funding. So here we have measures for liquidity and funding compared to total assets. We see these big shifts here in recent years. So, we've got the pandemic years where you see this big rise in liquidity. We've got a surge in deposits, lots of cash. And then all of a sudden, that's all reversed in the past year or two. And then on the flip side of that,-- well, related to that I would say is the trends in funding. Non-deposit funding has increased.

So, in the next slide we can get into

that a little bit more. So, we see these large swings in deposits, mostly after a big surge during the pandemic years. Deposit flows have declined-- deposits have declined in the banking industry. Many of this reflects consumers searching for higher yields. Within the banking industry, there's been a shift towards interest-bearing deposits, CDs, money market deposits as well as other time deposits, and also, we've seen this outflow to the money market funds which offer higher yields compared to bank deposits.

Although banks have increased deposit rates, they do remain below market rates, and this has also challenged the banking industry as they've had to raise rates, had to also look for other sources of liquidity, turning to non-deposit liabilities, turning to brokered deposits and other sources of funding such as Federal Home Loan Bank funding.

So that sort of wraps up the, sort of,

liquidity and funding conditions. I'll turn it over to Camille now for a discussion of credit.

MS. SCHMIDT: Thanks, Krishna.

So, like she said, I'm going to shift the discussion to some bank lending and potential credit risk areas. And I'd like to start with commercial real estate.

The dollar volume of bank-held CRE loans is at an historic high; it's over $3 trillion, and with that a growing number of banks hold CRE loan concentrations. So, as you can see on this chart over-- around 1,400 banks had a concentration of total CRE loans greater than 300 percent of capital and reserves, or of construction and development loans over 100 percent of capital and reserves as of second quarter.

And on this chart, if you look at the blue bars; and this shows exactly what the Chairman was talking about earlier, you can see that the vast majority of them are institutions

with under $10 billion in assets. That's the blue portion of the bar. So those are the banks that you we generally consider community banks. And not on this chart, but there are several hundred of those that have concentrations over 400 or 500 percent.

And as we've been saying, -you've all heard about what's going on in the CRE market, so I'm not going to talk about that much, but you know that these structural changes post-pandemic have really affected the office market. And so, office loans coming due in the near term in the next year or two are really going to face an uphill battle refinancing. Those borrowers are facing rising interest rates, reduced cash flows from low,-- or from higher vacancy rates, lower property values, and tightening credit conditions.

I'd also like to talk about consumer lending because both bank and non-bank consumer lending has been growing consistently since

second quarter of 2020. And in recent quarters, credit card balances and other consumer loan balances have grown at a very fast clip, rising 16 percent and over 12 percent, respectively, in just the past year.

So, the delinquency rates on these institutions with material exposures to credit card lending or auto or other consumer loans is-- still remains manageable, but those ratios are increasing. And I just mentioned this because I think discretionary spending is often the first to be cut when budgets come under pressure. And the consumers have held up the economies for a few years, but we are seeing some strength in leisure spending starting to level off. And it's really uncertain how consumer spending will shape up in the coming months as several economists are expecting it to moderate.

So American consumers face some obstacles such as student loan repayments starting back up, a growing debt service. Those

debt-to-income ratios are higher. They've got shrinking savings accounts and many banks are tightening their lending standards on top of that.

Then, finally, I will just mention residential lending because that market continues to deal with high interest rates driving a low housing supply and reduced affordability, and nationally home price appreciation continues. It slowed, but as I checked this morning, it seems to be kind of picking up again.

So, I'm interested to hear about how the banks you supervise are dealing with all of these issues and where you as regulators are potentially challenging-- or changing some of your supervisory efforts and programs. Same way for interest rate risk and funding. It's all on the board. So, if any of you would like to start telling us about what maybe you're seeing or what the things we've talked about might trigger.

MR. HAGLER: Hi. I'll chime in.

MS. SCHMIDT: Okay. Thanks, Kevin.

MR. HAGLER: Kevin Hagler from Georgia. You probably saw me flinch when you were talking about the CRE concentrations. That was on purpose, yes. So, we're looking through that. And again, in a world where it's an average, so there's somebody driving up the average. And then we've got some outliers within our own average. It's definitely an area that I'm concerned about.

Of course we examine for it. My portfolio is your portfolio. We're almost all, except for two banks, are FDIC banks. So, the measuring, the monitoring, the diversification of the-- all those pieces are so much better than they were before. But I still don't take much comfort in that knowing the impact of it, so an area that we're going to continue to watch.

We all worry about the office. I'm just not sure that I see a lot of that in our portfolio. I'm not sure exactly who does the

lending for the office, but I don't think it's the community banks. But it may be-- they may be lending to entities that benefit from those offices being filled, so I don't think we can get away with it too easily.

But as far as the rising interest rates, the biggest feedback I've received from the bankers I talk to is just that the shocks have been so great that their,-- and I don't-- I'm not quoting them, but their models are unreliable at this point. They probably wouldn't admit that officially, but yes, I think that's the true sentiment.

They're all supposed to be asset sensitive. So, as you saw, the net interest margins were growing as rates went up, but at some point, I think the rates got so high that they could not-- either borrowers couldn't afford to borrow at that rate or are just choosing not to. So, then they lost that momentum on the top end.

And as you pointed out, the deposit rates are catching them on the bottom. So, it wouldn't normally be like that in a slow rising rate. I think that's what they are running into, but it does worry me that their modeling can't seem to handle that. So, if they're going to try to take any action based on that in terms of hedging or swaps or anything like that, I don't think they've got a good data set to do that reliably. But that's just the general feel from what I'm seeing.

MS. SCHMIDT: Thank you. I will comment to your comment about office space. We have soft data from our examiners that are at community banks telling us that there is more exposure at these banks to multifamily and retail. And we see that whether-- when we cut it by different total asset size groups or our regions, all of them, are still again soft, more kind of survey-like data, showing more exposure to multifamily and retail. Office maybe coming

in third over-- compared to other things. So please let me know if you're seeing otherwise.

MR. HAGLER: Sounds good.

MS. SCHMIDT: That would be helpful.

Does someone else want to comment over here? We've got plenty of time, so you'll all get to speak.

MR. C. COOPER: I'll mention and-- chime in. Charles Cooper of Texas. Agree with everything Kevin said. I think on the soft data you're talking about, that's where we need to focus as much as we can to try to develop that. In Texas where the economy is still -is strong I do believe that because of everything that's happened historically our bankers have a better grasp of the issues that they need to deal with and have more data from their customers than they've ever had before. So, I think that's a very-- it's a positive. I do believe that there will be some soft spots possibly in certain markets and in certain geographical areas.

About the rising rate environment, as of June 30, the NIM in our banks has improved, but I do think a lot of them are asset- sensitive. I think the 9/30 data that we're beginning to get in may show a little bit different trend there.

And since you say what other risks concern you, stuff that they ask us, what keeps you up at night, I have to say, Mr. Chairman, that I'm always concerned about cyber risk. I think the ransomware is proliferating. The exposure the banks have to third-party service providers is increasing, and I just think we have to maintain our vigilance and focus in that regard.

MS. SCHMIDT: Very good. And I think we'll hear about third-party this afternoon.

Oh, Tony?

MR. SALAZAR: Tony Salazar, State of Maryland. And I would echo Charles' comment about the cyber, from our office's perspective, what we're worried about. We did have one bank

that had an episode with that. And fortunately it was a small bank, but it proved up how devastating that can be. Particularly if it were a larger institution, it would be a big problem.

In terms of the institutions, one of the things that we're hearing is a lot of concern over the uncertainties both on the lending-- on the customer side and on the bank side. So, uncertainties over how long and where rates are going to go, just regulatory uncertainty. And a lot of that's leading to loan growth, at least in the Maryland. I think you probably know around this area it's just still there. It's just not going at the rates they had been used to before, maybe matching the economy, which is kind of in Maryland, moving along, but not-- gangbusters. So, they're matching that.

But we have not seen issues with liquidity in our institutions. That's all pretty stable. They're managing the net interest margin pretty well. And loans, they seem to be

diversified, at least on the CRA, not CRA, CRE front and things like that. So, we're concerned about what we don't know more than anything else. And like I said, I think that uncertainty has a lot of people hesitant to maybe make any big bets.

MS. SCHMIDT: Are any of you seeing any changes in lending standards? Tightening rather than-- presuming not-- maybe not much loosening. Again our soft data, the Senior Loan Officer Survey talked about tightening lending, but our soft data, what our examiners are telling is they're not really seeing that, that most bankers are telling them they've kind of stayed the same. A few have tightened, but not a lot.

So, if any of you have comments on that or appraisals that you've seen, recent appraisals?

MS. EBERLEY: So, we do have --

MS. SCHMIDT: Oh.

MS. EBERLEY: Sorry. We have a comment. Greg Gonzales has his hand up in Webex.

If we can get him. - Good.

MR. GONZALES: Thank you.

MS. EBERLEY: Sure.

MR. GONZALES: I agree with everything that's been said. I was just going to say on the CRE, certainly concentrations increased. Really, we're just trying to take it on a bank-by-bank basis. We learned so much during the Great Recession with respect to a number of institutions having significant concentrations, but being able to manage through them well. And we think that's going to be the case again. We also saw some institutions that were well below those thresholds and had some challenges. So, it's just really a question of bank by bank and what type of economic environment for that community and experience in staffing.

I'd also say that on the other risk or concerns I'd be interested in hearing from the FDIC with respect to the-- sort of a follow-up on Charles Cooper's comment on cybersecurity. I'd

be interested in hearing the attitude with respect to adoption of technology, emerging technologies. We had a few comments from institutions that are interested in looking at some things but just curious as to the regulators' attitude towards that. We think that it's important for community banks to have the ability to explore and maybe adopt certain technologies, but we'd love to hear any conversation along that line.

MS. EBERLEY: Sure, Greg. Thank you. I'm not sure exactly what kind of technology you're speaking about, but I'm going to make a presumption to start and you can hop back in and correct me if I'm wrong.

But my guess is that you're talking about technologies that can partner with a bank's core provider to help it with cybersecurity defenses. Am I on the right track?

MR. GONZALES: That, and really just looking for general attitude and as to what do we

tell institutions should they have an interest?

One of the things that I've heard is institutions want to be relevant, want to able to compete, and, to a degree, they need to be able to explore emerging technologies. So, I don't have one technology to point to, but just a general comment would be helpful. Thank you.

MS. EBERLEY: Okay. So, it sounds like you're speaking more about partnering with third parties to provide products and services to the customer base, and that's absolutely something that we're supportive of. It helps community banks to be able to provide products and services and compete with larger institutions that may be able to do that directly.

I think there's-- we've heard from community banks that there are challenges in getting their cores, to the extent that those products and services or the technology needs to connect through the core, there are challenges. And the cores have told us that those challenges

relate to their need to prevent ransomware attacks on the core and making sure that the core remains safe and sound. But that's something that we're absolutely happy to facilitate the conversations and keep those conversations moving forward.

The broader question I think will fall under a later agenda item when we talk about third-party risk management and really the banks' responsibilities when they're partnering with a third party and what they need to do. So, if I can defer that until that conversation, I'd like to do that, if that's okay.

MR. GONZALES: That would be great. And I have a follow up before we get to the third-party risk management guides. I have a follow up on that point, too, so thank you.

MS. EBERLEY: Okay. Terrific. Thanks.

MR. HAGLER: I would say in a bit of irony that we had a financial institution this

year that had a breach, a cyber event, and, but it was through the telephone banking system, so very old tech is where the breach came through. And then the real issue that's getting to be super expensive is one that you all read about, too, is the washing of the checks. In fact, I had somebody come through my neighborhood the other day and clean out everybody's mailbox looking for checks. So, yes. So, and I appreciate the focus on new and improved technology, but it seems to be the old school stuff that's been expensive this year in Georgia.

MR. J. COOPER: And, Doreen, and I mentioned that earlier that more concern about check fraud and being connected by effectively organized crime and that it's not a one-off kind of situation. So clearly hearing that from other states.

And I think from the association of state bank regulators' perspective, we've been on a listening tour for the last few months with our

district meetings and we convene our five districts. And I think one observation I'd make is that particularly with commercial real estate, it's a very large and diverse marketplace. And I think the state regulators largely have a good handle on what's going on in their banks, and the more coordination, collaboration, communication that we have with our federal regulatory counterparts I think we get to better conclusions.

And in particular, it's clear that the large urban areas are under more stress, particularly in office space. In many communities, there's a lack of affordable housing, and I think concern about constricting credit for commercial real estate and building new homes. So, I think there's some risk from the regulatory response perspective that we actually limit investment. So, I think it's not showing up in terms of performance at this point. There seems to be more equity in deals than in

past, kind of, times of economic uncertainty. So, I think right now from what I hear more, still relatively confident in asset quality.

On the funding side, it's interesting because I look at the charts, and I tend to index on 2019 as, kind of, prepandemic. And it seems like at that time, 2019, liquidity and funding was a bigger concern. We went through this, kind of, economic, months of fiscal stimulus, lots of monetary stimulus. And now it seems to be normalizing a bit. So, I think it's an interesting kind of exercise to compare back to 2019. Where are we on the funding side? But clearly banks are being disintermediated, particularly on the larger deposits, and move into more, higher-yielding instruments.

So, I think just kind of final observation, we've been running a Community Bank Sentiment Index since 2019, and last quarter, quarter 2, was the absolute lowest that it has ever been. And it did tick up in the third

quarter slightly, so there's a bit more optimism from the community bankers that we surveyed, but I would still say that it's not a very optimistic view.

So, it gives us some perspective into how they are feeling, and particularly, I think they're concerned about monetary policy and what that does to their ability to attract and retain deposits. They're concerned about regulatory reaction to the events of March. Cybersecurity continues to be a major risk.

MS. KRUSE: Is it my turn?

(Laughter.)

MS. KRUSE: I'm Lisa Kruse from North Dakota, and I just wanted-- I totally agree with everything that has already been said. I think cybersecurity is definitely top-of-mind for all of us, especially due to the global environment right now.

But specifically to your questions, I agree with what has been said. As far as us

changing any exam procedures, I don't really see that. I think they have a good framework in place. We are focusing on liquidity. Maybe pushing a little bit harder, making sure that banks have actually tested their lines and their borrowing lines.

And also, I think what I appreciate, too, is, and I think FDIC and us have since the crisis-- when you look at the Call Report and you get the commercial real estate percentage, we are making our examiners look a little closer. Is it diversified? Is it all hotels? Is it all office? I mean, it really makes a difference how we treat that. And if it is diversified. And what we're seeing that-- and then I think it's helpful and makes it a little more common sense than grouping all commercial real estate as the same because the risk is not.

MS. EBERLEY: Very true.

MS. KRUSE: Like offices is obviously what we're more concerned about at this point.

And I'm fairly insulated. We have a lot of agriculture in our area, but it's the same there. Any concentration we really need to look deeper to see what makes that up.

I just wanted to address something a little bit more global, or for the whole financial industry. So, that also affects the banking industry, and that is like the non-bank arena. And I think it's very important to talk about right now. And I wanted to point to Chairman Gruenberg.

At the Exchequer Club you made some comments about that, especially when it comes to mortgage lending. And we share your concerns obviously. Since the financial crisis, mortgage lending has moved from banks to nonbanks. Seventy percent is now the nonbanks, and seven of the ten largest mortgage lenders are nonbanks. And that's where state regulators-- we kind of come into play because we license the nonbanks, the mortgage lenders, and the mortgage servicers,

and we also then see how it impacts our banking system.

So I just wanted to highlight a little bit about how we are addressing that on a state regulatory basis because of the incredible impact it has on the financial system. We took it upon ourselves. We need to address it. And like me as North Dakota, a small state, I've seen explosion in the nonbank licenses. And one thing that we've done is to work together as a state system to come up with credential standards, especially for mortgage servicers. And it covers capital, liquidity, and also corporate governance requirements. And I think that's very important to be aware of, that we have that already developed. And with the states that so far have implemented these credential standards, we cover 98 percent of the mortgage servicing market.

And also, since we are collecting data on these entities, and I know it has an impact on

the financial system, we are more than willing to share data points or anything we see in this market. And we would love to have that dialogue. If there's anything that you feel would help you as our partner and-- as our partner, in overseeing the financial system, we definitely have that data and we would love to-- if there's anything specific that you would like to see or we can do better in our partnership in sharing, we are,-- I think we're all in this together, and we want to make sure our financial system is protected.

MS. SCHMIDT: Thank you for that offer, because we are always looking for more information on that non-bank sector.

Others? Kevin?

MR. ALLARD: Just as far as the interest rate increases, the pace at which that happened in unprecedented. The fact that they could be sustained for some period of time, I don't think we've seen that fully play out in

terms of banks and margin compression and/or liquidity and funding risk.

Switching to credit risk, I think we all know there's a significant volume of leases that are resetting, loan terms that are going to reset, new cap rates are going to be utilized. As far as Ohio banks, talking specifically about office space, I don't know that that's prevalent on Ohio bank balance sheets, but I do wonder what the spillover effect may be when those market forces come to bear.

The other comment, kind of going along with what Charles said, I think we all worked with our banks during the last crisis to talk about the importance of concentration risk management. I think they got that lesson very well. So, my hope is that banks are better prepared to deal with this cycle.

MS. GALLAGHER: I'm Mary Gallagher from Massachusetts. I agree with everything that's already been said, so I'm not going to

rehash, but towards the end of your comments, Camille, I appreciate the macro-economic environment mentioned student loans. That's actually another area that the states-- we're at the table as, at least in Massachusetts and many other states, licensing student loan servicers. And there is a pain point with the return to payment. You have three-and-a-half years of deferred,-- a huge amount of money-- deferred payment. And I worry about the consumer having to have a monthly payment when everything else is so expensive.

MS. SCHMIDT: Right.

MS. GALLAGHER: So, this is an area at a macro level that I think there could be pain to come.

Lisa, you're right, it's,-- we're talking about banks. This is-- that's what we do. It's a big part of what we do, but we also have these other areas and the overall financial industry and where the consumer will be is a big

concern.

MS. SCHMIDT: That's a good point.

So, has everyone had their opportunity? I think we might have a --

MR. THOMPSON: This is Mick Thompson, Oklahoma. I just would rehash everything that's already said, so every time I make a note, somebody come up with the same thing, and I know Marty doesn't want to hear it again.

But I would say that one thing we're really monitoring closely is the repricing of loans because what's going to happen to that consumer who's now paying $500 a month and now all of a sudden he's got to pay $1,000 a month? So, we're really,-- whatever kind of loan it is, we're watching those pretty closely as the repricing starts happening. Loans pay off and then they got to start higher payments. And that's going to be an issue.

State, as far as we're-- we're in very good shape. We have no issues as far as the

income for the state. The biggest savings account we've ever had in our state. So that side is okay. But as this repricing happens that's a real concern to us.

MS. SCHMIDT: Good. Is there anyone on the-- attending virtually that would like to comment?

MS. EBERLEY: Melanie just raised her hand. Melanie?

MS. HALL: Hi there. Thank you so much for making a virtual option available. Traveling to D.C. from Montana isn't always easy, and so I appreciate being able to participate in this way.

Because the good Commissioner from Oklahoma brought up repricing risk, one of the things that we're watching carefully is actually probably a small problem, but it is something that I could see coming up as an exam issue, and that is we have community banks here in Montana that, due to interest rate issues, are having

challenges in the residential real estate market with customers being able to afford the takeout on a construction loan.

They're getting to the end of the construction process and due to increased costs of housing and housing construction here, the borrower is not necessarily able to qualify for a loan in the secondary market. And so, we have banks working with customers to try to sort of bridge the gap until rates come back down and maybe they're able to afford to get into a more traditional mortgage.

So I just raise this as a-- I don't think this is an issue for-- that's going to collapse the global economy, but I do think that it is an issue that we might have examiners seeing going forward that we need to provide some direction and support for our community banks, quite frankly, doing this in order to help customers get from a construction loan into hopefully a mortgage loan at some point in the

future. The speed at which rates have increased has really impacted construction lending, especially in states that are housing-challenged in the way that Montana is right now. Thank you.

MS. EBERLEY: Thanks, Melanie. It's a good reminder that we have guidance outstanding in so many places that talk about the importance of working with borrowers and working with them early, and that usually leads to the best outcome. And I think you just emphasized that point for us.

So, let's see. Dawn Holstein has her hand raised.

MS. HOLSTEIN: Hi everyone. Yes, just to chime in for-- with everyone. Totally in agreement. I'm Dawn Holstein from West Virginia. And on your economic charts I think we were probably one of the lowest in GDP growth. But to that point we're also typically not a big boom state, but also not a big bust state, so we've stayed relatively constant. I agree with all the

points that have been made today. Very accurate to West Virginia as well. Our monitoring has, of course, been heightened, but no real changes to our examination function.

But one point that was brought up to me by more than one of our bankers is the Banker Term Funding Program. And as Commissioner Kruse mentioned, we have emphasized testing your lines, making sure there would be liquidity available in case that there would be a need, but there is also kind of an un-found stigma to participating. And I just wondered if you had any comments on that or any experience with those types of concerns regarding the program.

MS. EBERLEY: Yes, thanks, Dawn. We've certainly heard the concern and done our best to emphasize from a regulatory standpoint there is absolutely no stigma to using the discount window, making sure you've got access, getting your collateral cleared, being ready, and also to using the Bank Term Funding Program.

We conducted a webinar; we being the Federal Reserve, the FDIC, and the OCC, back in May where we delivered this message. And then we updated our interagency guidance where we also delivered the same message; and that was in July, that it's important to have a variety of funding sources. The more the better, you know? And that really is the goal behind having a contingency liquidity funding plan. A contingency plan that focuses just on one source of liquidity is not much of a contingency.

And so, depending on the speed of need, the amount of need, there are going to be different sources that are going to be better sources. So, it's really important. And that's one thing that we've been reinforcing through our exam program. I think you have, too. But we continue to hear the pushback on the stigma, and I think we all just have to work collectively to say that's not the case. There is no stigma. It makes sense for banks to be prepared. That's what

they're supposed to do. Thank you for raising that.

MR. C. COOPER: Doreen, if I could follow up on that? I completely agree with the collaboration I think we've been able to do in this regard. When the focus turned to liquidity, I think that some of the banks felt like they could tap into that-- those funds very easily. When we started asking questions about it, it became obvious that maybe they needed to do a little bit more due diligence and prepare.

I do think though that through the effort that was all put out into our examination process the questions our examiners are asking, at least in my opinion, our banks have better data in this regard. It's easier now to get the liquidity numbers that before it might have taken a week for them to provide. Now you can basically get it in an hour or so. That means a CEO can get the information quicker. And I just think that just shows that when we work together, I

think we can come out with a much better product. And so I'm very comfortable now that our banks-- their systems are even better than they were, let's just say in April.

MS. EBERLEY: Thank you.

MS. SCHMIDT: Any other comments?

(No audible response.)

MS. SCHMIDT: I'd like to just close with one comment to follow up on something James said about the importance of communication between the agencies on commercial real estate. And if you're not aware, we do have a CRE Working Group that the CSBS participates on. We meet at least quarterly. And we're talking about things like the CRE sectors, the exposures, what we're seeing in appraisal values, kind of, out-of-area lending, and loan grading systems. So, we are comparing that information. So,-- if you weren't aware, I wanted you to be aware of that. And we're learning a lot, and that is important to our strategy.

So, Doreen, do you have some closing remarks?

MS. EBERLEY: No, I just really want to thank you. And maybe I'll,-- actually I will touch on one thing. Kevin, I think you said it, that what you were saying is that institutions generally had better risk management practices this go-around. And I would say through this monitoring effort, we've all been monitoring our institutions for a number of years now, coming really out of the last crisis; we never stopped, and actually heightened a bit.

So, we're seeing the same thing. We're seeing a general improvement in risk management practices over time, fewer criticisms of risk management practices. So, banks doing a good job. And you also raised the point that there were institutions that were highly concentrated, but they had good risk management practices and they made it through last time. They didn't fail, right? They might have had

some asset quality issues, but they recovered. There were institutions that had lower concentrations and not very good practices at all, and they succumbed. And so, it really is about management's focus on managing that concentration risk.

Okay. Thank you. Camille and Krishna, I really appreciate it.

And thanks to everybody for the really great discussion. We'll go ahead and move onto our next topic, which is Nikita Pearson, who is Deputy to the Chairman for External Affairs and Director of our Office of Minority and Women Inclusion. And Nikita is going to provide an update on the 2022 Financial Institution Diversity Self Assessments.

Thanks, Nikita.

MS. PEARSON: Good afternoon. So, I'm from Georgia like Kevin, so good afternoon.

(Laughter.)

MS. PEARSON: All right. Thank you.

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So how many of you have heard about the Financial institution Diversity Self Assessment?

A couple of you? Okay. Great. Awesome. So, I'm here to share a little bit more about that with you today. And so, you should know that as I share with you, I'll share with you about the program, the purpose of the program, how we administer the program, what we're trying to accomplish. I ask you to think about the questions that you have. I'm happy to answer any questions that you have.

I didn't come to the table without an ask. I have an ask of you. And also know that you should feel free to have uncomfortable conversations with me. I'm comfortable with having those uncomfortable conversations. Coming from being a bank examiner supervision over to this work I've learned to be comfortable having uncomfortable conversations.

As I go through the program today some of the things that I will do is make sure that

you first know that we do this work as a part of Section 342 of the Dodd-Frank Act. Section 342 came about in 2010. Then in 2015 the agencies issued the policy statement that set forth these standards. And in the standards we then started putting out the diversity self-assessment. This is a voluntary self-assessment that we issue out to banks.

Now, we found that although the FDIC is the primary federal regulator for over 3,000 banks, that less than 200 actually voluntarily submit the self-assessment to us. And when I had the opportunity to come over to OMWI, one of the first questions I asked myself is why is that?

OMWI has the responsibility of assessing diversity policies and practices of the banks that we regulate, but I think one of the first things that we needed to do is to translate this purpose into banker language. It's not just an exercise of collecting data. This is really an exercise of helping a financial institution

take an assessment of where they are and how can they better position themselves to better serve their communities and better service their banks, to position their banks to be-- in a better financial position. And let me tell you what I mean by that.

Remember that I said I'm a Commissioned bank examiner, so I couldn't help myself. In 2019, the Federal Reserve issued a study that said, that revenue ratios increased once the share of women on the board increased just 17 percent. Just 17 percent of women on the board increased revenue ratios. In 2015, McKinsey issued a study that found that businesses in the top quartile for racial and ethnic diversity are 35 percent more likely to have financial returns that are above the national industry.

You've heard a lot of challenges facing the industry. When you have a diversity of thought, you have an opportunity there to have

different chances to have innovation to address these challenges. So, I say all these things to say, this isn't an exercise, a regulatory exercise, it's not a "nice to have." It is good for business. And we as regulators, it is important for us to promote this.

So, when I think about this, we talk about, in our examination function, that management is a key factor for the success of a bank. Diversity, equity, inclusion, and accessibility helps promote that. I just pointed to a study from a peer regulator that points to how this effort can help support revenue or the earnings of a bank. I also pointed to, or I'm sure I can find, a number of different studies to talk to how diversity can also help promote how a bank may better help serve their community if they have more representation from a community.

So, with all those things being said, I ask myself,-- we put those things out and we rebranded it the way that we communicated this

out and put it into banker language,-- why still do we not get this information from financial institutions? And I got some feedback.

First feedback was that our financial institutions do not trust us with this information. That is because they think we're going to use it against them, and it will show up in their examinations. We do not use it in their examinations. It is not included in our safety and soundness, consumer protection, or CRA performance evaluations.

They believe that their information will be shared. We by law are required to follow FOIA, but otherwise we do not share individual bank data.

They do not believe that they have the time or resources to do it. They have a lot of things to do, particularly community banks. The large banks have chief diversity officers, but the smaller banks, community banks do not. We've worked through the process to automate what we do

to reduce the amount of time. And then for the banks that file EEO1s, they'll find a lot of the information that we ask for, they already have it because they complete EEO1s or they have affirmative action plans.

In addition to that, they do not have to submit the information to us in the format that we request it in. They can actually submit,-- if they want to just send us their affirmative action plan or their EEO-1, they can just send it to us that way. We prefer it in our format, but they can send it to us in any format that they choose to.

They also think that they-- they're concerned about-- they don't have a good story to tell, so they don't want to send it to us. And what I say to them is that this is just an assessment of where you are, and it's up to you on what you decide to share with us. If you decide not to answer a question, you don't have to answer the question. We'd prefer that you

answer all the questions, but you don't have to.

So those are some of the things that we've heard. And so, my ask of you today and the reason that I'm sharing this with you is because my desire is to share with you what I've heard, and so you'll know what the answers are. And so, if you hear this from the financial institutions, you'll know what to respond.

But if you don't remember anything else that I say today, it's only one thing that you need to remember. If a financial institution or your examiners have a question about the program, the only thing they need to remember is bankdiversity@fdic.gov. bankdiversity@fdic.gov. If they remember that email address and they send a question to us, someone from our office will get back to them and answer the question. We will work one on one with the financial institution.

The reason when we collect the data from the financial institution and how

we're-- our goal to help financial institutions. We collect the information, and we look for promising practices across the industry. Then we publish it out, out on our website. The reason this is particularly helpful for community banks is, again, community banks are likely not to have chief diversity officers and hire consultants to do this type of work for them. But we can identify those promising practices that may be beneficial, and they can look through it and determine something that they might want to try to explore. And that is how we can be beneficial with the information that's shared with us.

This is not a exercise of where we're just trying to collect data for the sake of having numbers and putting it out. This is an exercise of how can we help community banks not only prepare themselves to be stronger financial institutions, but also prepare themselves to better serve their communities. And that's how we view data should be used and collected. That

is the purpose of the Financial Institution Diversity Program, and that is our goal in administering the program.

So that's the gist of what my prepared remarks are, and now I want to pause there to see what questions you have for me.

MR. HAGLER: Nikita, I may have misunderstood. Did you say that the self assessments that are provided to the FDIC, would be subject to FOIA requests?

MS. PEARSON: They can be.

So, yes, so we're required by law to follow FOIA. There is, and so I'm looking for the attorneys in the room.

I'm not an attorney, Kevin, I'm an accountant. But there-- financial institutions can mark their self assessments as commercial, I can't remember what the term is.

So, let me get you the official response on that.

MR. HAGLER: Okay.

MS. PEARSON: It's in our Financial Institution Letter.

I'll get you an official answer, because I don't want to tell you the wrong thing. But it can be marked, but attorneys will have to look at it to determine how it applies to FOIA.

MR. SALAZAR: Nikita, do you provide a state breakdown on the number, on the banks that have responded?

So, for example, two in Maryland, 10 Oklahoma. Is there a way to figure out where the responses have come from?

MS. PEARSON: Yes, we do have that information, and we can get it for you.

MR. SALAZAR: Yes, that would be great. Thank you.

MS. PEARSON: Yes.

MS. GALLAGHER: Nikita, I'll just make an observation. I gave a speech four years ago and I talked about the McKinsey study, and I talked about Harvard Business School, and I talk

about diversity of thought and driving the bottom line.

And so, this is an area I care tremendously about for any business. And I'm proud that in Massachusetts, we have a number of banks that are run by women, that are, have diversity in senior management and in boards.

Our first deputy commissioner in Massachusetts, Cindy Begin, organized an event earlier this year with some stakeholders, including law firms, banks, this group called Bank on Women, which you probably are familiar with.

To try and promote board,-- bank,-- community banks increasing diversity on their boards.

We had a number of our banks participate, and I think we have real leadership in that space.

And there's always more, always more that can be done. So, I think this program is

very interesting. I like that Tony, it would be great to know, it's the voluntary nature is important.

But you know, if only 200 banks are participating, why aren't more, especially if you're delivering a message that this can actually help your bottom line.

We've been pushing that as a conversation piece in Massachusetts. And I'm proud of the institutions, certainly the institutions that we oversee in Massachusetts, because they are leading in this space.

So, I just thank you for your presentation.

MS. PEARSON: Thank you, Megan.

Interestingly enough, the Massachusetts Bankers Associations invited me not long ago to do a webinar with them.

And, there was a banker in the group who mentioned that their bank had completed the self-assessment every year since 2017, but

they've never sent it to us.

And, they found it to be particularly helpful, but because of the number of things that I mentioned, is why they never sent it.

But this year, we confirmed this year after that webinar they decided to send it to us for the very first time.

And so, I think it helps us to just have meeting people where they are. Having those engaging conversations, and just continuing to, to talk about it.

And having more and more people speaking about it's a good business case, having more and more people saying, having, sharing their good experiences with it, I think is particularly helpful.

Thank you for that.

MR. J. COOPER: Could, I have just one question. Could you, you mentioned promising practices.

And I think that, could you give a

little bit more information on, on that in terms of things that bank are doing to really promote this?

I mean, I recognize it has to start at the top of an organization, and you know, the whole, the whole notion is, is, has to be driven by executive leaders.

But lots of things, there's lots of components to it. Employee resource groups; other kinds of, other kinds of, you know, opportunities at the organizational level.

So, I'd just be curious and, kind of, what stands out in your mind.

MS. PEARSON: That's a great question.

One thing that stands out in my mind right now is recruitment, hiring, staffing. That's a common question that I hear about.

So, a promising practice that I hear about is how do you, and when I say you, the financial institution, engage with expanded group, or reach broader groups for potential

hires.

So, for example, financial institutions have shared with us that they're taking unique approaches to reach different groups.

So, they are partnering with for example, maybe high schools to have early entrance into hiring programs.

They are reaching out to minority serving institutions, maybe HBCUs, or Hispanic serving institutions.

They are maybe having some other type of work development, workforce development programs in their communities.

Because some mentioned that they may struggle with hiring. And, that's something that I found to be a promising practice.

So, how do you develop an interest in a career to come into a financial institution early on, and to get the desire for a community bank, for that applicant to want to stay at that

community bank in that community versus coming on and then going on to another area, a large urban area, or a larger bank, right. And, how do you do that?

And in addition to that, another promising practice is, what type of workplace flexibilities are being offered for different groups of people to be able to maintain their work/life balance, and their, you know, their family responsibilities, as well as their work responsibilities.

So, those are the different types of things.

Did I answer your question?

MR. J. COOPER: No, that's good.

MS. PEARSON: All right. What other questions do you have for me? About how we administer the programs, what you've heard?

(No audible response.)

MS. PEARSON: All right, thank you.

(Chorus of thank you's.)

MS. EBERLEY: Okay, thanks, Nikita, so much. Really appreciate it.

For our next agenda item, I'm going to invite up a few colleagues and we're going to touch on a number of matters.

We're going to start off with Suzie Clair, Associate Director of Capital Markets from the Division of Risk Management Supervision.

And, Suzie's going to talk about funding and liquidity risk management.

After that, we're going to have Tom Lyons, Associate Director in the Division of Risk Management Supervision Policy Branch.

And Tom's going to talk about the guidance on commercial real estate, loan accommodations, and work outs.

And then after that, Tom and Luke Brown, who is Associate Director for the Supervisory Policy Branch in the Division of Depositor and Consumer Protection, are going to speak about our guidance on third-party risk

management.

And then lastly, Chris Finnegan, you can wait if you want, Chris, either way. But Chris Finnegan and I will, Chris is Senior Deputy Director of Compliance and CRA Exams in the Division of Depositor and Consumer Protection.

And Chris and I are going to talk about our return to banks, since our examiners have been back onsite at bank examinations for just over a year now.

And then finally, I'll touch on training that the FDIC has provided to state examiners this year.

So, we'll go ahead and get started and I'll turn it over to Suzie.

MS. CLAIR: Thanks, Doreen. And my comments actually, I think Krishna stole some of my thunder. But more from a macro perspective. So, I was going to talk about liquidity and funding, and interest rate risk.

But my slides actually are going to

focus on, and charts are going to focus on the trends at community institutions, and kind of layer on some of the, the high-level macro charts that Krishna described earlier, to see some of the trends in recent quarters.

And, my data here today is as of June 30th, so, and the way rates have gone in September, we think that there's going to be more unrealized losses on investment securities.

And again, as the Chairman mentioned, headwinds for institutions regarding the interest rate risk outlook, and economic conditions.

So, this first slide shows the effect of rising rates on, on bank earnings again for community institutions through June.

You see as we talked about the Fed funds rate is in the dash green line, and that is you know, we've all noticed is rose significantly at a very sharp pace.

And concurrently, we've seen recently that the cost of funds has taken an increase.

And that has outpaced the yield on earning assets in the first half of the year. And, that's leading to declining net interest margins.

On the next slide, we look at the effects of rising rates on liquidity. Again, and similar to what Krishna said earlier about the increases in wholesale funding, and deposit declines, these trends are shown for community institutions.

So, you see that wholesale funding is increasing as domestic deposits have declined. And, loans and leases have picked up.

Again, securities portfolios, and this is reflected at cost, are showing declines overall for community institutions.

So again, you know, we saw the reverse in the decline in the loan trend. So that funding is, is coming from the, the uptick in wholesale and after declines in deposits.

So, in the next slide, we see that the rising interest rates is leading to higher cost

of funds for institutions. And that deposit costs are rising.

This slide illustrates here the composition and growth in the weighted average cost of funds, is overlaid as the red dotted line.

And, you see that over the past two quarters, that community banks saw shifts from MMDA and other savings accounts, into time deposits.

And, the shift in deposit types could be coupled with the increasing market rates, contribute to the significant increase in weighted average cost of funds for community banks.

So, moving to the next slide, as we mentioned on the prior slide, over the past year there's been a significant increase in wholesale funding.

And this growth is due in, predominantly in borrowing. It's centered in borrowings, brokered, and reciprocal deposits.

As of the second quarter, as of June 2023, the volume of brokered at community banks is shown in light blue, is at the highest level since at least 2018, increasing from $86 billion at year end, to $112 billion.

Reciprocals shown in yellow here, are at a new peak, increasing from nearly $70 billion at year-end 2022, to $100 billion as of the second quarter.

And then borrowings, shown in green, including Federal Home Loan Bank and other borrowings, are shown, other borrowings are shown in purple.

Those two increased from $108 billion at year end, to $143 billion in the second quarter.

And then, our last data slide will take a look at the impact that higher rates have had on investment portfolios.

And these are the unrealized losses that we've been talking about, and the Chairman

mentioned earlier.

Again, this is through second quarter, and we expect that there will be even higher levels in, as of the September numbers given where rates landed at September 29th.

So, when we look at this chart, again you see the rapid increase in unrealized losses. And this is in both available for sale, and held to maturity securities, in both of those categories.

And it's consistent with the jump in the 10-year constant maturity, maturing Treasury rate that's shown in the dash blue line overlaid there.

So, from a capital perspective, you have AFS and HTM net unrealized holding losses that are net of tax.

They're not factored into regulatory capital for most community banks, because they've opted out of AOCI net gains or losses on treatment for AFS securities, in accordance with the

generally applicable capital rules.

So again, additionally held maturity securities aren't measured at fair value for financial reporting purposes.

So, equity capital is defined by generally acceptable accounting principles, or GAAP, does reflect AFS unrealized holding losses, net unrealized holding losses.

So therefore, there are some institutions that we have seen that have significantly lower GAAP equity compared to regulatory capital. In some cases, even negative GAAP equity.

And, those institutions can face various stresses as far as counter-parties willing to lend to them, and restrictions that those counter-parties may place on funding.

So again, it's also important to point out that most of the bonds that have these market value declines, it's not really a credit risk issue, it's more of a market risk issue.

So, there may not be credit issues, but the market risk presented in these bonds with significant unrealized holding losses has various implications for banks' liquidity, and capital.

So, moving to the next slide, this is just a highlight of the guidance that Doreen had mentioned earlier, that was issued on July 28th by the federal banking agencies.

Again, it really, it reiterates the importance of contingency funding planning. And the events of 2023 underscored the importance of robust liquidity risk management, and contingency funding planning.

Again, this update serves as a reminder to maintain actionable funding plans, contingent funding plans that take into account a range of possible stress scenarios.

These are the highlights of the statement. And again, as Lisa mentioned the importance of, emphasizes the importance of testing the available borrowing lines.

And as Doreen had mentioned, the statement encourages institutions to explore the discount window.

And while it explicitly doesn't mention the BTFP, that is also considered and encouraged by the institute, by the agencies.

So again, also just pointing to the last bullet is, again, the importance of revising those plans as conditions change. So, and understanding operational challenges.

MS. EBERLEY: Okay.

So, we've talked about liquidity a little bit. We've got a couple of ways we can go. We can stop and do Q&A now, we can go all the way through the presentations and do Q&A at the end.

Anybody want to start with questions now, or would you like to wait?

(No audible response.)

MS. EBERLEY: Okay, we'll wait. All right, Tom, you're up.

MR. LYONS: Well, thank you.

So, I want to talk a little bit about the prudent CRE loan accommodations and work outs guidance, that we had issued in June.

So, on June 29, 2023, the banking agencies and the NCUA, issued the interagency policy statements on prudent commercial real estate loan accommodations and work outs.

The statement was published in the Federal Register on July 6th, and it's a principles-based resource for institutions to consider when engaging borrowers experiencing financial difficulties.

It updates and replaces the Interagency Statement that was issued in late 2009. And, given the myriad of challenges and risks facing CRE lending, the agencies in consultation with the state regulators, decided to update and expand upon the 2009 statement.

Currently, more than 98 percent of banks engage in CRE lending. And, CRE loans are

the largest loan portfolio category in nearly half of institutions.

Further, the dollar volume of CRE lending is at an historic high, recently peaking at more than 3 billion.

And nearly 30 percent of the banks have a concentration of CRE loans exceeding 300 percent of capital, or acquisition, or acquisition and development and construction loans exceeding 100 percent of capital.

So, in 2020, the COVID pandemic led to stress across several property types, including hospitality, office, retail, entertainment, office, I've read office already.

The office sector remains particularly vulnerable. Some borrows may have difficulty refinancing, given the structural decline in office demand.

Regardless of the CRE sector, CRE borrowers' abilities to manage through a period of softer economic conditions, including supply

chain imbalances, labor challenges, geo-political tension, inflation, rising rates, will impact the magnitude and direction of risk in 2023, and beyond.

So, on the next slide, we cover, it talks a little bit about the objectives here. So, this statement discusses the importance of working constructively with CRE borrowers who are experiencing financial difficulty, and would be appropriate for all institutions engaged in CRE lending.

The agencies recognize that prudent CRE accommodations and workouts are often in the best interest of both the financial institution, and the borrower.

Accordingly, the statement reaffirms key principles from the 2009 statement that financial institutions that implement prudent CRE loan workout arrangements, after performing a comprehensive review of a borrower's financial condition, will not be subject to criticism for

engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse classification.

And, modified loans to borrowers who have the ability to repay their debts according to reasonably established terms, will not be subject to adverse classification solely because the value of their underlying collateral has declined, to an amount that is less than the loan balance.

So, the statement adds a new section on short-term accommodations. So short term and less complex CRE accommodations are a tool that can be used before a loan requires more complex work out scenario.

It reflects changes in GAAP since 2009, including the current expected credit loss methodology.

The statement also updates the original six examples, plus provides some new examples for multi-family ADC construction, and

income-producing hotel.

So, the statement was issued for industry comments fall of last year, and we received 22 comments. And, the statement was revised based on that feedback.

So next slide, please.

So, on September 14, 2023, the Federal Reserve hosted an ask the regulator session on the prudent CRE statements.

Speakers from the banking agencies and the NCUA walked through the guidance, which included a deep dive into the nine workout examples, one of the examples we included in the CRE statement and the principles discussed in the guidance.

The presentation had approximately 3,400 participants, received numerous questions. Most of the questions were related to case specific issues on how the guidance would apply to a particular scenario, including if a particular workout would be accrual, or

nonaccrual, pass, or would be adversely classified. And how a bank could use the A/B note solution, which would be splitting the loan into two notes, with one note representing loss and charge off, with the second note also representing the remaining balance that is put on prudent repayment terms.

So, in essence, it's a very high-level discussion of the CRE statement. And, happy to take questions now or at the end. So ,I think we're going to the end, right?

So, we're going to talk about the third party, and I'll kick it over to Luke to start us off.

MR. BROWN: Good afternoon. Good afternoon, can you hear me okay? Good afternoon everybody.

As Doreen mentioned and Tom just mentioned, Tom and I will be giving you a high-level overview of the interagency third-party risk management guidance that the agencies issued

last June.

I've already heard today a couple questions focused on third-party risk management, so we look forward to having a conversation with you.

Slide 2.

Prior to the agencies issuing the inter-agency guidance, each of the agencies had issued their own separate guidance for risk management, risk management purposes.

Each agency generally included the same principles in its guidance, but there were differences in scope and number of examples.

Given that each agency issued separate guidance on the same topic, some entities were unsure of whether the various guidances conveyed consistent messages related to third-party risk management.

Slide 3, please.

Therefore, in developing the interagency guidance, the agencies sought to work

together to make their guidance consistent, and articulate clear risk-based principles for third-party risk management.

In considering feedback received, the agencies understood that because of the increase in the number and types of third-party relationships, banks, particularly community banks, might find examples of considerations useful in identifying and managing risk associated with a wide range of third-party relationships and for all stages of the lifestyle of a third-party relationship.

In July 2021, the agencies issued proposed interagency guidance on third-party risk management in the Federal Register, seeking public comment.

Slide 4, please.

In the aggregate, the agencies received over 80 comments for consideration in developing the final guidance.

The FDIC, OCC, and Federal Reserve

Board, reviewed and carefully considered the public comments that we received. And issued the final guidance in June of 2023.

And upon issuing the final guidance in June, each of the agencies rescinded their previously issued guidances.

The final inter-agency guidance provides a general framework which we'll talk about, which gives institutions flexibilities as they apply it.

And, it's a resource to assist them in implementation of effective third-party risk management processes.

As you know, banks use many types of third parties for numerous functions. All activities present some level of risk, so effective risk management is always important, particularly when a third party is engaged to provide a service, or conduct an activity for a bank.

The inter-agency guidance reminds

institutions of this key principle. Whether activities are performed internally or via a third party, financial institutions are required to operate in a safe and sound manner, and in compliance with all applicable laws and regulations, including those designed to protect consumers.

Also, banks use a, use third parties does not diminish their responsibilities to meet these requirements, to the same extent as if they had actually performed those duties themselves.

Recognizing that there are a wide variety of third-party relationships for varying purposes, the guidance promotes tailored risk management practices commensurate with the risk profile, the nature of the relationship, and the appetite of the institution.

With that, I will pass the baton on to my colleagues, Tom Lyons.

MR. LYONS: Thanks, Luke.

So, slide 5.

So as Luke had mentioned, the guidance is principles-based resource. It's not mandatory that institutions you know, apply the guidance.

The guidance is not intended as a check list, nor does it provide a safe harbor. The guidance serves as a resource to assist institutions in implementing a third-party risk management, you know, practices by providing examples of considerations in each stage of the risk management life cycle.

So, those are the planning stage, the due diligence stage, doing a contract negotiation, ongoing monitoring, and termination.

So, the principles and examples of the considerations addressed in the guidance are meant to be applied in a risk-focused manner, to take into account the level of risk, complexity, and size of the institution as well as the nature of the specific third-party relationship.

Which brings us to the next slide, on

slide 6, which is tailoring it. Tailoring is a key theme throughout the guidance.

An institution can consider which activities discussed in the guidance within each stage might be appropriate for that institution, depending on the situation.

And, can tailor its third-party risk management program to its specific relationship and risks.

An institution may need to incorporate different considerations and factors, such as those that may be found in more specialized or topic-specific guidance, to appropriately manage the risks from some types of third-party relationships.

The guidance also talks about governance. This section discusses the roles and responsibilities of the board and management, the role of independent reviews to assess related controls, and documentation and reporting considerations to provide the necessary

information for assessing the effectiveness of the third-party risk management processes.

It highlights that the institution's board, board of directors, has the ultimate responsibility for providing oversight for the third-party risk management, and holding management accountable.

And, it also notes that institutions are free to structure their third-party risk management processes in a variety of ways, as long as the processes provide effective risk management with accountability throughout the third-party risk management life cycle.

There is a section on supervision. So, on the supervisory review section, it discusses how examiners will assess a bank's third-party risk management practices.

And, a key message from that section is that examiners will not examine to the guidance, but will evaluate the risks in this, in the third-party relationships, the effectiveness

of risk management processes, and whether activities are conducted in a safe and sound manner in compliance with applicable laws and regulations, including those for consumer protection.

Next slide, please.

So, this slide, we have a number of resources that are available on FDIC's webpage. And these, you know, relate to rules that would be most often applicable.

The safety and soundness standards, the information securities standards, and you know, guidance.

There's a due diligence guide that the agencies had put out a couple years ago for community banks. And, it points to the banker resource center.

So last point I just want to get across, is that relationships that are only between banks and their direct customers of traditional bank products and services, such as

deposit accounts, or retail, or commercial loans, would not be addressed in the third-party risk management framework that we discuss here.

Those would be covered by various risk management processes and rules, that apply to traditional lending and deposit relationships.

For instance, we have the safety and soundness standards for Part 364, for underwriting and other various rules for AML, and customer due diligence. Those would cover those.

And with that, I'm happy to take any questions on third party, or any of the other items.

MS. EBERLEY: Okay. Well, we'll wrap up. I want to share a few comments on training and on our back to examination work.

And, then we can open up. We'd like to hear your views on any of these topics.

But I think one of the key, this is the section of the agenda is called State and Federal Coordination.

And one of the key ways that we coordinate is through our examination activities that we do, either on an alternating, concurrent, or joint basis.

And also, in training our examiners. And so, I'll start with training, and I wanted to share with you that to date, we have, the FDIC has hosted approximately 627 state examiners and five training sessions.

And, these are on topics including current expected credit losses implementation, minority depository institution refresher training, and revised instructions for special mention.

And then in November, we've got a couple of other offerings coming. One on state only training on third-party relationships are really to talk about this guidance.

And then in 2024, we plan to offer a state only minority depository institution refresher training session.

In addition to that, 378 state examiners have attended the FDIC's pre-commissioned examiner courses. And, an additional 177 are registered to attend a course through the end of this year.

Finally, 128 state examiners have attended FFIEC schools, while an additional 33 examiners are registered to attend by the end of this year.

So, a key commitment to continue to provide training across the industry, or the agencies.

Back to banks front, I wanted to share a little bit with you that we went back to banks, it was a year ago really, last September, when we ended our mandatory telework period, and then our maximum telework period.

And so, it's been a little over a year. I would say, and I think Chris would agree with me, that we had a little bit of a slow start of people adjusting, and trying to figure out how

to manage a team of examiners differently than we did before.

Previously, you started the examination offsite. You went onsite as a team. You finished offsite.

And now we've got folks kind of in different places throughout that examination process, from planning, to submitting a final report of examination.

But I will say, you know, in the past few months, I would really say over the summer it feels like we've really gotten into a groove, and that the exam teams are really embracing the new processes.

We'd been working to reduce onsite examination hours before the pandemic. That was a key employee retention initiative for us.

And so, for RMS, we had reduced our onsite percentage from about 70 percent to about 50 percent of the examination.

In DCP, prior to the pandemic was

about 60 percent offsite. And then since we've come back, our onsite percentages are a little bit lower than that.

We're really trying to leverage what we have learned through mandatory telework, and take advantage of it. Take advantage of the technology that we adopted, thank goodness, before mandatory telework.

That we had really started exploring these things or it would have been very, very difficult to pivot. So, I'm glad that we had headed down the path that we did.

I would say that the feedback that we're getting thus far, is really very good. Pre-commissioned examiners in particular, are so excited to be in banks, to be working with their co-workers.

Very difficult job to learn sitting around a table, or you know, a virtual table when everybody's on their own home and you have to ping somebody on a screen to ask a question.

Much easier if they're sitting together in either the bank, or the field office.

And, we've heard really positive feedback from bankers, as well. We've been doing a round of the banker outreach sessions here in Washington, over the past couple of months.

And they routinely give us positive feedback. We also get positive feedback through our post-examination surveys that bankers are very happy to have examiners back in person, being able to speak to them face-to-face.

It's just, it's a different kind of communication, and very much valued.

I'm happy to say too, we had lost, well not happy about this part, we'd lost some efficiency during mandatory telework.

It actually took us longer to complete examinations on the safety and soundness side, anyhow, when we were completely offsite, than it did when we were completely in person.

We've regained some of that efficiency

now that we're back. We're not 100 percent yet. We're not back to where we were.

I'm not sure we will be because we've added some procedures. Some a little before the pandemic; some during the pandemic.

So, we're hitting a new normal, but we've recaptured some of the efficiency that we lost.

And I think, you know, one challenge that we still all need to really focus on, and I really appreciate your views on this, is ensuring good communication when we've got team members in different locations.

It's different right, we're not all offsite, onsite, offsite. It's people everywhere.

And, it's not just FDIC examiners when it's joint. It's the state examiners, as well. And then you have the banker that's possibly in a third location. And maybe some folks are with the banker, some folks aren't.

What kind of tools can we give our examiners in support, to make sure that we've got the best communication possible in those scenarios.

So, we really just wanted to bring that up, and get a feel from you how you are looking at it, what your thoughts were. Anything that you think we need to work on collectively.

And we'll open up the conversation for that, or any of our other topics, training, third party, commercial real estate work outs, or liquidity and funds management.

And it looks like I may have something online here. No, okay.

MR. FINNEGAN: And Doreen, I'll just add one thing if I could. What we did on the consumer compliance side, is that I echo everything that Doreen just mentioned.

We have learned, you know, over the pandemic when we went, you know, 100 percent offsite. It has been a tad bit of a slow start

coming out.

And, we're getting somewhat near where we were before the pandemic. But we did do some lessons learned.

What we learned during the pandemic and on that efficiency as we come out. So, we're trying to do different technology. We were talking about that earlier.

Different things that we could do in this hybrid world that we have with the bank, and examiners being all different ways.

So, one thing we did do, was on our consumer compliance manual back in September about a month or so ago, we updated that with some, kind of, guidance on what we were doing onsite/offsite.

So, this is, it's in our, you know, public exam manual so it gives the bankers an idea, as well as our examiners, things that we do, kind of, expect that would be done onsite versus offsite.

And, some of the onsite things is the meetings are very important. Observing what's going on at the institution, and those kind of things.

So, we actually put that in as part of our exam manual. And we also updated our manual on our complex bank program, which we made permanent in the last year or so because again, there's a lot of offsite work that's done there.

But it's very important for us to have that onsite presence, as Doreen mentioned. And, I think you all agree to that.

It's all based on risk, you know, we don't set a certain percent needs to be onsite/offsite, but it's based on the risk of that institution with our examiner-in-charge working with their local supervisors on that.

But we have gotten, just like Doreen said, we've gotten a lot of good positive feedback from the bankers about us being back onsite with doing these exams.

And, I think it makes it a stronger exam. And we actually require every exam to have some onsite presence, so.

MR. HAGLER: Yes, if I could, just a couple comments.

Doreen, I am particular about the examination program. I agree with everything you said, and the feedback I'm getting back from the bankers too, is that they greatly appreciate and enjoy the hybrid approach.

The only negative comment I got, and it may be a little dated at this point, was the prolonged exam cycle. And I assume they were talking about my team, not yours.

But yes, I think that would be universal that it was, and I think it was that, we've probably gotten a lot better at it now.

But the coordinating and the funneling questions through a central point. Just the logistic pieces.

Because I think at first we were

driving them crazy with everybody asking everybody questions via email. Then funneled it and working that out.

So, I think that-- that's come a long ways.

I think it was a fed seminar earlier this week that was talking about a study that they were citing that said completely offsite showed a 3 to 10 percent decline in efficiency.

Hybrid was somewhere between 13 to 20 percent increase in efficiency.

So, I think it was bearing out what we were experiencing. But that's a sweet spot to be in now, and going forward.

As far as the CRE accommodations and workouts document, it made a lot of sense to me, and I really like the timing of it.

Because it really telegraphs a warning to the industry, especially the one in my state, that we're talking about workouts and accommodations here, maybe you should rethink

some of those concentrations in that area.

So, I'm sure that wasn't well, it wasn't very subtle I thought, but I loved it. So appreciated the timing of that, whether that was intentional or not.

MS. EBERLEY: Yes.

MR. HAGLER: Suzanne, your comments with regard to the inter-agency statement. I appreciate that even in the highlighted version, you brought in the concept of operational readiness three times.

I think, you know we've all examined for CFPs over the years. But it became very real after the spring.

So, I think the more we can reiterate those concepts and operational readiness as regulators, the better.

MS. EBERLEY: Thanks.

I will note that Greg Gonzales has his hand raised. Greg? And Greg did ask a question earlier, Tom, that I said we would defer to this

session.

I think it's probably for you and Luke.

MR. GONZALES: Yes, just a couple of things.

First on the hybrid exams, just to echo that, you know, we're hearing a lot of good comments from our institutions with regard to hybrids.

And we're trying to, you know, just based on risk, trying to scope that out on a exam by exam basis. So, good comments there.

On the third-party guidance, maybe a couple things. I've heard some comments from a community banking standpoint, that you know, it's still challenging to understand how to go about tailoring that guidance to the risk profile, in a way that would meet the federal agency's expectations.

Are you all working on anything to provide any additional tools that might help

community banks appropriately calibrate?

MR. LYONS: Do you want to start?

MR. BROWN: Go ahead.

MR. LYONS: So, I know one thing, Greg, thank you very much for that question, Greg. Really do appreciate that.

One of the things that we are talking about with the Fed and the OCC, is additional resources that we may be able to put out there, specifically for community banks.

We are discussing with them, you know, what additional resources that we have. I really don't have anything to give you any details on that, but it is something that we're continuing those discussions and hopefully, we'll be able to talk with you about that more thoroughly in the near future.

We did have a conversation, ask the regulator call that was hosted by the St. Louis Fed.

So that, we did have that back in

July. And took a lot of questions, and we responded to a lot of questions on the third party as it related to that.

And I think you hit on one thing that we tried to get across in the guidance, which was the tailoring aspect, you know, for the institution.

So, what makes sense for the institution, and what makes sense for, you know, that particular, you know, activity that they're engaged in is really where we're trying to, to drive them is make sure that they're thinking about this broadly.

What makes sense for that activity. Different activities or different relationships are going to require different, just based on what it is, a different way to manage that, that relationship.

Some of them are going to be more important, so you're going to, institutions really should put a lot more attention on that.

Because there's more reliance on that particular activity. Others, it may be a little bit less.

You know, do you need the same kind of risk management processes for say, you know, someone that maintains the grounds and your branch network as it is, you know, for somebody who's got, who handles all your data processing.

So, it's different things for different folks, and not everything's going to be, you know, it's not a one size fits all.

So, it's a challenge, but the institution should be thinking about it and how they're best going to be protecting themselves in managing that relationship, so that they understand the risks that it presents to the institution and design their risk management processes that way.

Luke?

MR. BROWN: Yes, I can't really add much to that. The guidance just went out in June.

There's a lot of information in that guidance and as John, as Tom just described, it's a framework.

And maybe that's kind of part of the question. It's not a checklist where you just go, you know, from 1 to 10 and you take these steps.

It's really driven sort of bank to bank and quite frankly, relationship to relationship. You know, each relationship is entirely different. The risk is entirely different.

And so, there might be sort of a discomfort in that it does not have the specific answers, but it provides a framework in terms of these are the things you should be thinking about. These are the types of risks you should focus on. This is the type of due diligence you should have.

And, the agency spent a lot of time in putting all these concepts together in one coherent place.

And hopefully it will be helpful, but that's a helpful comment to be aware of.

Thank you.

MR. GONZALES: Yes, and I appreciate those comments on that. That's very helpful. One last question.

I was curious as to and you touched on it with regard to how supervise how examiners may be using this.

Could you speak to that as to whether your examiners will cite to this guidance at this point, with regard to any issues that they may see, with regard to third-party risk management?

MR. BROWN: Should I go first this time?

MR. LYONS: You go first.

MR. BROWN: So, this is guidance. It's not a regulation. So, this is not a requirement. What it does is it lays out a number of supervisory and risk management concepts for a bank to understand and to navigate as they're

trying to mitigate risks.

I'll say from the consumer compliance perspective, you know, again, it's not guidance so I'm sorry, not a rule so we would not cite to it.

But we would do a compliance management review, and we'd analyze the relationship and the risks, and the activities that the institution has been engaged in from a compliance risk perspective.

And you know, we would certainly take appropriate actions if we saw any concerns from a risk perspective.

But we won't be citing to the guidance itself.

MR. GONZALES: Okay. That's very helpful to me. Thank you so much.

MS. EBERLEY: Yes, Greg, I want to add just a couple more thoughts.

And, you know, when examiners talk about challenges that an institution is having

with respect to a third-party relationship, the underlying problems, I mean the third-party guidance tells institutions how to comply with the law.

You know, it gives institutions guidance about the things they need to do to make sure that they stay in compliance.

The laws that actually underpin this, that we frequently see challenges with, are internal controls and management information systems.

Those two standards, and the safety and soundness standards in Part 364. And also the Bank Secrecy Act.

So, that's, I'm talking about on the deposit side of third-party relationships. If you're talking about the lending side, I would add ability to repay, as well.

So, those are the things that an institution has to pay attention to. The guidance helps them create a framework that will

help them engage in the activity, and compliance with law and guidelines.

The other thing I wanted to point to so that we don't forget about it, is that in August of 2021, the FDIC, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency, issued a guide specifically for community banks about how to conduct due diligence on Fintech companies, financial technology companies that they were interested in partnering with.

So that's for the FDIC, it's Financial Institution Letter 59-2021. But it gives practical advice about how to go through the due diligence process.

And, that's one of the things I think it's fair to say we hear from community banks that is a challenge for them, knowing where to start with the due diligence, having limited resources to conduct the due diligence.

So having a resource guide that helps

them, and gives them some guidance about you know, where to start, what to consider, I think is helpful, and I did want to point that that's still outstanding on our website.

MR. GONZALES: Good, thank you and I look forward to hearing anything more about additional tools that you may be working on, so thank you.

MS. EBERLEY: Thank you.

MR. C. COOPER: So, Doreen, I'd like to make two comments. First on training.

I think we all agree that training a bank examiner is, is so important. And I firmly believe that once an examiner is trained properly, that when they go out and they have to meet things like offsite, onsite, they can be very adaptable.

But we have to get the training done first. And so, we all need to concentrate on that.

Y'all do a great job on that, and but

if they're not trained, none of it works. I mean, we're going back to basics on that.

And then, kind of a follow-up on something else. On the commercial real estate work out guidance that you first started talking about, one of the things you said was that the guidance was in consultation with the states. And that was true.

And then on the third-party risk, third-party guidance, it was solo without the states.

And so I get a little bit confused sometimes why things are done with the states, some things are done without the states.

Since we do roughly 50 percent of the work, I guess we could argue over that a little bit.

But 50 percent of the work, 79 percent of all the banks are state chartered. So by number, we regulate more banks than anybody.

I just would like for us to try to

explore how we can participate more in these guidances. I do think we can bring some things to the table, that would be beneficial.

I think we're, I've always said, we're a little bit closer to the fire possibly than our federal counterparts.

So I just, I request that possibly on these guidances that we look for how to bring the states more involved in it.

MS. EBERLEY: Thank you.

MR. THOMPSON: I'd like to make a couple of comments that first thing on the training, I really appreciate the ability to help put the state examiners in the training program.

Because I agree with Charles 100 percent. If they're not trained, then it's a problem for the bank, and for us. So, I appreciate the training we get.

And, we've been back onsite in Oklahoma for a little over, probably a couple years. We're one of the states that our governor

didn't shut much down.

So, we were out early on. But what we did was we called every bank and talked to them about do you want us to be onsite, what do you want.

And then, at that time since it was really shut down time, was I allowed the examiner charge to make his choice whether he wanted to go onsite.

Because it was right in the height of that. And so, 90 percent of them wanted us to have somebody in the bank.

Some of the real small banks would say, we don't want those folks from Oklahoma City coming down here, because they're going to bring COVID to us. So, we didn't go to those banks.

But we've been doing the offsite/onsite for, like I said, little over two years. And it's really helped us as far as timing because when you, when you have to go to the panhandle of Oklahoma and you finish your

examination on Wednesday or Thursday, you can't drive out there for a one-day deal.

Well now when they finish it on Wednesday or Thursday, they go to the next bank because they're doing it offsite.

So, we're actually worked ahead. And we work very closely with Oklahoma City FDIC when they weren't going into the banks, and it was their exam, we would still send somebody for them to communicate, so you'd have somebody there although it wasn't the FDIC.

It was the State doing it. So, we were, kind of, working with them ahead of when they couldn't go into the bank.

And so, it's worked very good for us. We don't plan on ever going back to 100 percent in because we're doing particularly all BSA, IT and that offsite. The bank doesn't know where you are anyway on those.

But on, particularly on loans that are complex, we're going onsite looking at those,

always my EIC and detail would be onsite, and we're there to do the wrap up.

So, and it seems to be working very well with us, and the cooperating with the FDIC now that they are going back onsite.

MS. EBERLEY: Great, thanks.

MR. ALLARD: We've been back in banks since probably August of 2021, and I know we all stress the importance of communication to our examiners.

But even in this hybrid environment, it's even more important.

MS. EBERLEY: Yes.

MR. ALLARD: My observation would be I think our teams collectively have gotten very good at understanding what conversations they need to have at the bank, and what conversations they can have more in a remote manner.

MR. C. COOPER: Yes, I agree.

MS. EBERLEY: Okay.

All right, well that actually brings

us to the end of our agenda. I really appreciate everybody's participation, and the good conversation. So, thank you very much.

I want to thank all of our presenters, thank you. Thank you to all of our committee members for traveling in, and those that are participating virtually, thank you very much.

Before we close, I do want to give our leadership a chance to make some comments. Vice Chairman Hill?

VICE CHAIRMAN HILL: Nothing from me. Thanks, everyone.

MS. EBERLEY: Director McKernan?

(No audible response.)

MS. EBERLEY: Chairman Gruenberg?

CHAIRMAN GRUENBERG: Thanks, Doreen.

Just to thank you all for your time and your participation. Very helpful discussion today; to be continued.

Thank you all.

(Chorus of thank you's.)

CHAIRMAN GRUENBERG: And thanks to the staff for their excellent presentation.

MS. EBERLEY: Thank you very much.

(Whereupon, the above entitled matter went off the record at 2:53 p.m.)